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THE INTERNATIONAL MONETARY STABILITY ACT OF 1999—S. 1879

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC POLICY

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

ON

S. 1879

TO AMEND THE INTERNATIONAL MONETARY STABILITY ACT AND TO SHARE
CURRENCY WITH OFFICIALLY DOLLARIZED COUNTRIES

FEBRUARY 8, 2000

before the use of the Committee on Banking, Housing, and Urban Affairs



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(III)

THE INTERNATIONAL MONETARY STABILITY ACT OF 1999—S. 1879

TUESDAY, FEBRUARY 8, 2000

**U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON ECONOMIC POLICY,
Washington, DC.**

The Subcommittee met at 10:02 a.m., in room SD-628 of the Dirksen Senate Office Building, Senator Connie Mack (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR CONNIE MACK

Senator MACK. The Subcommittee will come to order.

First of all, I would like to thank Assistant Secretary Truman for appearing before the Subcommittee today. Until last year, Secretary Truman was, for many years, the Federal Reserve's leading expert on international economic issues. This background makes him uniquely qualified to testify on these matters. Again, as I mentioned to you earlier, thank you for your testimony this morning, for your being here, and for the comments last night when we had an opportunity to chat.

In the 1980's, the foreign policy of the United States was dedicated to spreading freedom and democracy. Now it's time to spread sound money. If freedom and democracy are to remain secure, people need to have rising standards of living, and to accomplish that, sound money is essential.

Early last year, then-Argentine President Carlos Saúl Menem announced that Argentina was considering dollarization. Interest in dollarization immediately spread throughout Latin America.

In response to this interest, we held two hearings on dollarization last year. These hearings convinced me that dollarization is not an economic panacea and is not an excuse to avoid other reforms, but it is a good way to achieve sound money, and sound money is essential for strong, long-term economic growth. Dollarization will reduce inflation and interest rates and spur savings and investment. These two hearings also convinced me that the issue of currency profits has to be addressed.

Even if a country decides the economic benefits of dollarization outweigh the costs, it may refrain from dollarizing because of the transfer of currency profits to the United States. As an elected representative, I understand quite well that the opponents of dollarization may claim the loss of currency profits will have to come out of needed government programs. That is why I introduced the International Monetary Stability Act. The bill will give the Treasury

Secretary the discretion, and I emphasize discretion, to rebate currency profits to countries that dollarize.

The bill is designed to appeal both to dollarization supporters and dollarization skeptics. Dollarization supporters get to remove the loss of currency profits as a roadblock to dollarization. Dollarization skeptics should understand that the decision to dollarize remains each country's to make for itself. The United States will not impose dollarization on anyone. We can't, for that matter. And we won't share currency profits unless the Treasury Secretary thinks dollarization will be successful.

Sharing currency profits will not be a "seal of approval" for all of a country's economic policies; it will simply indicate that sharing currency profits with a country is in the interest of the United States. In effect, this bill lets the United States export the principle of price stability. The dollarization issue is much too important for the United States to just stand by passively. If the United States refuses to take a position, dollarization will continue to be considered only by countries in crisis, rather than being an option they consider during relatively stable times.

Back in 1992, Treasury Secretary Summers, then with the World Bank, said:

Finding ways of bribing people to dollarize, or at least giving back the extra seigniorage that is earned when dollarization takes place, ought to be an international priority. For the world as a whole, the advantages of dollarization seem clear to me.

When I asked him about this at the hearing last April, his only caveat was that as a Treasury official, he now had to be more cautious about how the United States spends its revenue. I believe this concern can be addressed and that the bill will be "scored" as a revenue gainer for the United States.

It is also important to note that I welcome any suggestions and recommendations on the bill from other offices on Capitol Hill, the Administration, the private sector, and even from abroad.

Again, Secretary Truman, we are delighted to have you here. We look forward to your comments.

**OPENING STATEMENT OF EDWIN M. TRUMAN
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. DEPARTMENT OF THE TREASURY**

Mr. TRUMAN. Thank you very much, Mr. Chairman. I thank you for the opportunity to testify on the issue of dollarization and your proposed legislation that would establish a framework for potentially sharing seigniorage with countries that decide to dollarize. This is a fascinating issue, as we discussed last night. Given the interest in dollarization recently expressed in several Central and South American countries, your initiative is highly relevant. The issue of dollarization has many economic, financial, and political dimensions. In my testimony this morning, I will focus primarily on the economic and financial aspects.

As the Administration has stated in prior testimony on the subject of dollarization, we do not have a view on whether dollarization is advisable in general. Each country, in principle, can dollarize unilaterally, and must bear the responsibility to decide in light of its own economic and political circumstances if dollarization is the appropriate policy to pursue.

From the U.S. perspective, as Secretary Summers testified last April, it would not be appropriate for U.S. authorities to adjust the procedures or orientation of U.S. monetary policy in light of another country's adoption of the dollar, to extend banking supervision to that country's banks, or to provide access by those banks to the Federal Reserve's discount window. We have not changed our view. On the issue of seigniorage sharing, as we have said earlier, congressional action would be required to permit the United States to rebate seigniorage to a dollarizing country. Further, we believe strongly that, during the process of deciding whether to share seigniorage with any given country, there should be extensive consultation by the Administration with the Congress to limit the scope for subsequent problems. The technical issues associated with dollarization are many and complex, and we would also certainly want to draw upon the expertise of other agencies, including the Federal Reserve.

A country's decision to end the legal tender status of its national currency and to bestow that status on the U.S. dollar is momentous, regardless of the circumstances. The reasons a country may choose to dollarize may be varied, and the benefits are potentially significant. However, it is essential to remember that dollarization cannot substitute for sound macroeconomic policies, robust institutions, and flexible markets. The principal economic benefits of dollarization are the credibility and policy discipline derived from its implicit irrevocability. The principal economic cost is the renunciation of national monetary autonomy.

The basic trade-off associated with dollarization is between the advantages and disadvantages of a regime with some degree of exchange rate and monetary policy flexibility and a regime with none. Exchange rate adjustment is a potential shock absorber and also allows greater scope for national monetary autonomy. However, that potential must be balanced against the added macroeconomic policy discipline and credibility associated with rejecting all scope for discretionary monetary policy and adopting the currency and monetary policy of a country with such credibility, a country with sound money, as you said, Mr. Chairman.

As in all meaningful trade-offs, judgments about the appropriate balance can differ across countries and their circumstances. Moreover, sound fundamental policies and institutions are needed to underpin any credible currency regime. In particular, a dollarizing country, like all countries, should have a sustainable fiscal position, a healthy banking system, flexible and well-functioning labor markets, open capital markets, and an environment in which private property is respected and contracts are enforced.

In addition to assessing its economic fundamentals, a country considering dollarization must weigh carefully the potential benefits against the potential costs. On one hand, the implicit irrevocability of dollarization holds the promise of lower interest rates, lower inflation rates, higher levels of economic activity, greater financial stability, and deeper financial markets. These benefits can be expected to be especially attractive to a country with a record of financial instability and high inflation, but financial and fiscal crises may still occur with dollarization.

On the other hand, the monetary authorities of a dollarizing country would be ceding the capacity to use monetary or exchange rate policy to cushion the economy against external or internal economic or financial disturbances. Moreover, there is no guarantee that the exchange rate used to convert a country's domestic currency into dollars, thereby fixing the exchange rate irrevocably, will be the right exchange rate for the near term. Setting the conversion rate either too high or too low could have adverse implications for the real economy's short-term performance. Over time, if domestic prices and wages cannot adjust rapidly in response to disturbances, dollarization could also mean greater volatility in output and employment. Dollarization should not impede the ability of the authorities to provide very short-term liquidity to individual banking institutions, but the authorities would lose much of their scope to respond to a systemic threat to the banking system.

For a country that has already made a strong commitment to a permanently fixed exchange rate regime, the balance of considerations with respect to dollarization differs. The scope for adjustment working through the exchange rate or domestic monetary policy is, in principle at least, already limited. Therefore, the effective costs of dollarizing may be lower, along with the effective benefits. However, even a fixed exchange rate regime has an exit option, which is presumed to be lost with dollarization. Nevertheless, it is worth noting that many observers, including Paul Volcker, have suggested that, in the wake of continuing globalization, the years and decades ahead may see a dramatic decline in the number of independent currencies in the world.

Obviously, countries can choose to adopt the dollar as legal tender without our assent. However, we hope and expect that countries would consult with us in advance because there are potential benefits as well as costs to the United States from the adoption of such a policy. The benefits include increased seigniorage; reduced transaction costs for U.S. resident importers, exporters, borrowers, and lenders; the possibility of increased business for U.S. banks and other financial institutions; and the power and prestige that might be associated with having a more international currency. Indirectly, the United States would benefit from the increased economic activity or greater financial stability that would be expected in countries that dollarize successfully.

However, dollarization also involves potential costs or burdens for the United States. U.S. economic and regulatory policymakers could come under pressure from the authorities of the dollarized country to help support their economy's economic and financial stability. Questions likewise have been raised about the possible impact on attitudes toward the United States in a dollarized country at times of financial stress. To the extent that dollarization furthers economic and other ties, this would normally be expected to be seen as a benefit to both the United States and the dollarized country. However, in difficult times, or when U.S. monetary policy is considered inappropriate or inconvenient for the dollarized country, there would be the risk that U.S. policies would foster resentment and encourage policymakers to deflect any blame for their countries' problems onto the United States. Finally, if a substantial number of large countries should choose to dollarize, the monetary

and exchange rate flexibility now enjoyed by the United States would itself potentially be reduced.

A decision by another country to adopt the dollar as its currency would increase U.S. seigniorage revenues—in effect lowering the cost of financing U.S. Government debt and improving the U.S. fiscal balance—because such an action would be expected to lead to increased holdings abroad of dollar currency. However, the size of this increase in the short run, let alone over time, remains an unanswered empirical question. The question of whether it would be appropriate to share those revenues or savings is an important public policy question.

As noted above, dollarization may bring potential benefits to the United States as well as to the dollarizing country, but also potential costs.

Looking at seigniorage sharing narrowly, in principle, a decision by the United States to share seigniorage revenues associated with the increased amount of dollars in circulation as a consequence of a country's decision to dollarize would not cost the U.S. taxpayer anything. However, if a country would have dollarized anyway, or has large amounts of dollars circulating already, then sharing seigniorage by the United States would imply foregoing additional seigniorage revenues. At the same time, if the benefits of dollarization to a country are significant, they should outweigh the lost seigniorage. In other words, the deciding factor for either country, the United States or the country considering dollarization, should not be whether seigniorage would be shared.

One added potential risk to the United States from the sharing of seigniorage is that it may imply a degree of U.S. endorsement or ownership of a country's decision to dollarize. Unless carefully designed and implemented, dollarization could also lead to unintended legal or financial complications and potential liabilities for the United States, particularly if a country seeks creative ways to meet its banking system's short-run liquidity needs—to provide lender-of-last-resort support for the domestic banking system—by securitizing potential seigniorage flows.

Sharing of dollar seigniorage raises complex questions. For example, where would we draw the line on the sharing of seigniorage? If the United States decided to share our increased seigniorage with one dollarizing country, does that mean we would stand ready to share it with all countries that we view as meeting the economic criteria for dollarization and seigniorage sharing? How would we decide the right amount of seigniorage to share?

Your proposed legislation suggests answers to some of these questions. You have contributed importantly to the intellectual debate on both dollarization and seigniorage sharing. The proposed legislation offers one approach to arrangements for potential seigniorage sharing: that is, give the Treasury Secretary discretionary authority to rebate seigniorage to a specified degree to any country that makes such a request as long as it meets certain conditions. That approach has the advantage of providing a country that is considering dollarization with a framework within which to contemplate its decision and, in the process, may encourage responsible dollarization.

On the other hand, each country is likely to come to its decision to dollarize in the context of different economic, financial, and political circumstances, and U.S. attitudes toward that decision may differ depending on those circumstances. Another approach, therefore, would be to wait until a country makes a concrete request to share seigniorage and then consider specific legislation that would enable us to do so under the particular circumstances.

Let me mention some of the technical issues and complexities that would be involved in seigniorage sharing. The calculation of the appropriate amount of seigniorage to share is tricky. The Federal Reserve has only estimates of the total amount of dollars circulating outside the United States. We have no way of knowing the actual amount circulating abroad, and estimates of the amount used by the residents of any one country are even rougher. Thus, any formula for sharing seigniorage inherently would be only an approximation of the actual seigniorage lost by the dollarizing country or gained by the United States as a result of the country's decision to dollarize.

If it were decided to adopt seigniorage sharing as U.S. policy, important implementation challenges would arise in order to have reasonable confidence that the right amount is shared. U.S. taxpayers would want some assurance that they are not being exploited by seigniorage rebates to foreign countries in excess of the additional seigniorage being gained by the United States. While the approach suggested in the proposed legislation is plausible, several considerations would arise about its actual implementation. These include:

First, recognition that we would have no way of knowing the actual amount of U.S. currency in circulation in a given country at any point in time.

Second, it cannot be fully guaranteed that a country would not receive more than its fair share of seigniorage revenues. For example, the formula in the Chairman's proposed legislation assumes implicitly that the dollarized economy has the same income elasticity of demand for currency as does the United States and other countries in the world that use dollars. If the income elasticity of demand for currency were lower in the dollarizing economy, the seigniorage sharing calculated by the formula would be too large. This would also be the case if the demand for cash in a dollarizing country were to fall as the demand for other monetary aggregates rose, for example, as a result of increased intermediation or the repatriation of flight capital.

Third, some might raise questions about the appropriate interest rate to use as a proxy for the opportunity cost of holding cash in dollars. This is also not a matter that can be settled on a factual basis. One could argue that the interest rate on U.S. Government bonds would be appropriate because that rate most closely reflects the long-term liability nature of money. One could also argue that the 90-day Treasury bill rate, as specified in the proposed legislation, is more appropriate because it is a good proxy for the opportunity cost of holding reserves, as well as for the net return on the Federal Reserve's portfolio. Given the generally upward slope of the U.S. yield curve, the use of a short-term interest rate has the added benefit of being more conservative from a U.S. perspective

than the use of a long-term rate. Yet another concept might be the rate that the dollarizing country would have earned on its dollar-denominated assets, which depends on the composition of its portfolio of such assets.

Fourth, any approach for sharing seigniorage with countries that have already officially dollarized inherently cannot be expected to reflect with complete accuracy a country's actual holding of dollars now or in the future.

Fifth, some might raise questions about whether there should be some allowance for the ex-ante partial, but substantial, dollarization of countries, such as Argentina, that ultimately decide to fully and officially dollarize.

Nevertheless, these questions have reasonable answers as long as one is prepared in some instances to be satisfied with less than full precision.

I should also note that an approach to sharing seigniorage by means of paying interest on a consol issued by the United States would raise issues about the status of this security under the laws that govern the management of U.S. debt. Moreover, issues about the budgetary treatment and the full legislative implications of sharing seigniorage would have to be addressed.

Let me make one final comment on your thoughtful legislation. The ten factors that the Treasury Secretary would be required to take into consideration in determining whether to certify that a country has officially dollarized, and is eligible for seigniorage sharing, are definitely relevant to any such determination. However, there may be other important factors to consider as well before we decide to share our increased seigniorage. For example, dollarization is more likely to succeed in a given country if, at the time of dollarization, a country's foreign reserves cover at least the local currency in circulation, and the commitment of the country's citizens to dollarization is high. Moreover, the economic and financial context in which dollarization takes place can also play an important part in determining its success. Dollarization as part of a coherent, long-term economic strategy is likely to be more successful than dollarization in response to a financial crisis. The latter is more likely to involve hasty decisions with unforeseen consequences.

In conclusion, I want to commend you, Mr. Chairman, for your thoughtful proposal and many contributions to a complex and increasingly relevant policy discussion. We will want to continue an open dialogue with the Congress and other interested parties as we proceed to analyze further the many facets of this subject.

Thank you, Mr. Chairman, for your time. I would be happy to respond to any questions you may have.

Senator MACK. Again, thank you for your input this morning. I think you have covered the subject quite well. There are a series of questions that I would like to put to you this morning, but let me begin by restating what I said in my opening remarks.

The proposal is not etched in stone, it is actually intended to get this discussion underway. I believe, building on the thought of Paul Volcker, that over time, we are probably going to see fewer currencies. I guess it's not inconceivable that one could conclude that there could be three or four major trading blocs in the world each dominated by a single currency.

It seems to me fairly obvious that Latin America, at least at this point in history, would be looking to the United States. Therefore, my thinking has been that we should try to find a way to address the problems that might arise as countries move unilaterally to what they think is in their best interest. It was with that spirit that we have pursued this legislation and, again, we are totally open to discussions about the best way in which to go about it.

The questions you raised with respect to the seigniorage sharing formulas and so forth are very valid questions. These are things that we do want to work out.

Let me pose the first question. Are you comfortable with the Secretary having the discretion?

I sensed that perhaps you felt it would be nice if the Secretary didn't have that discretion and it was given back to us here in the Congress to make the decision on an individual basis.

Mr. TRUMAN. I believe, as I said in the testimony, the decision to dollarize is a consequential decision from the standpoint of the country and potentially from the perspective of the United States itself.

If we are going to be involved in the currency area, we want to have some sense if that's the appropriate way to proceed. As we work through this process, whatever framework is used, one would want to have very extensive consultations with the Congress, with other parts of the Administration, with the Federal Reserve on technical issues, on how one moved forward over time.

I believe the issue of discretion, if I may put it that way—not that I don't trust the Secretary of the Treasury, past, present, and future—in and of itself is not a particular problem because I would expect that any Secretary of the Treasury, using such authority, would want to make sure that everybody within the U.S. context was comfortable with any decision he was going to make.

Senator MACK. I'm just responding to my interpretation of your comments. I believe there was a statement made that perhaps the Congress might want to act on an individual basis.

Mr. TRUMAN. The other problem is that we are somewhat in a hypothetical world, as you and I discussed last night. It's easy to imagine 50 years down the road that there would be three or four major currencies in the world. Some people have speculated there may be only one because of the efficiency gains and the monetary stability that would be associated with that.

The interesting, challenging, intellectual question is how do we get from here to there? We have to start somewhere, as you have suggested. The question is whether we start by laying out a framework with some discretion, as you say, associated with that framework, or we proceed on a case-by-case basis. The advantage of a framework is that everybody, within certain reason, knows what that framework is, making it somewhat easier to make decisions.

The disadvantage is we may not have anticipated everything we might want to think of when a particular case comes up. That might say that we don't want to deal with that case and build on a case law approach to the dollarization itself, and to any seigniorage sharing that we decide would take place.

Quite frankly, being a good two-handed economist, I could think of good arguments on both sides.

Senator MACK. And you have.

It seems to me, and I suspect that's why it's in the legislation, that setting the framework up and providing discretion for the Secretary is the better approach to take. I would use as an example trade authority. The political climate can change over time and countries wouldn't really know where the Congress is going to be on this, as opposed to how we would hope Secretaries of the Treasury would be looking at the issue of seigniorage and dollarization from a more stable framework over time.

It seems to me that setting up the framework and providing discretion is probably a better way to go.

Mr. TRUMAN. That is certainly a very cogent argument, and I have no disagreement with it.

Senator MACK. Are there any other disadvantages you might want to raise with respect to the discretion being in the hands of the Secretary?

Mr. TRUMAN. As I have said, far be it from me not to trust the Secretaries of the Treasury, past, present, and future. They have always been upstanding people.

Maybe I should be careful not to endorse all 70 of them, but as a general rule, I think they are very responsible individuals and would want to be very careful as in the case of the analogy you used, trade legislation. You have a framework for negotiating trade legislation, but there is a high degree of consultation in implementing that framework. One would want to make sure there are no surprises, and I think one would want to make sure that there was a broad consensus that this is the way to go.

I think the challenge is not the second country that dollarizes and with which we share seigniorage; the challenge is the first country. We would want to make sure that we got it right. That is the case whether it was done on an ad hoc basis or operating within a framework, because the first precedent would be important for how the framework would be applied on down the road.

I'm sure the Treasury Department, whichever route was taken, would want to be very careful and examine the issue up, down, and sideways as it goes forward. We would want to make sure there was broad political consensus that this is the way to go, for a whole variety of reasons, partly having to do with the fact that we would be rebating revenues from the Government, and we would be taking a consequential step, a small step but a consequential step.

I think we would want to make sure to make an effort to have a broad consensus, to educate the American people about what the nature of this enterprise is all about. But that's not beyond our capacity to deal with under either type of framework. I think the challenge will be in how we would apply the framework, or how we would go about selling the individual approach.

Senator MACK. Before I begin asking some questions related to the seigniorage, the formula, and so forth, I want to ask you about something that was triggered by your comment about whether the country is fully aware of, understands, and supports the issue of dollarization.

It seems to me that there are two broad categories of interests from a U.S. perspective. One is on the economic side: What are the benefits or detriments to the country as a result of other countries

dollarizing? My instincts tell me that from an economic perspective, they are all benefits.

The other is on the political side. As you, I believe, indicated in your testimony, there could be problems in the future in which politicians in other countries would use dollarization and control of monetary policy in the hands of another country as a scapegoat for problems their country may be experiencing.

It seems to me, with respect to those two broad categories, on the economic side, the benefits would be a plus for the United States. The downside may be on the political side.

Mr. TRUMAN. I think it depends upon where one draws the line between the economic and the political. It is not an accident that economics used to be called political economy, if I may put it that way. To the extent, for example, as I mentioned in my testimony, that you have some questions about the country's use of the seigniorage flow, which in turn raise economic, legal, and potential financial questions—that would be both a political issue and an economic issue.

Setting aside pressure placed on the United States to alter its policies, or not to alter its policies for that matter, the only other consideration—and I confess that this is an economist's argument which comes from the literature on optimal currency areas—is the fact that exchange rates are fundamentally a two-sided instrument. There's our side, and there's the foreign country's side. As another country limits its capacity to use exchange rate flexibility, so likewise it is limiting, in some sense, our capacity to use exchange rate flexibility.

Now, if you are talking about relatively small countries, that's not consequential for us. But, in a broader context, ultimately it might mean that we, too, would have less capacity to let the dollar rise or fall relative to some large set of countries, the rest of the world, and that might make us better or worse off.

In some sense, somewhere down the pike, we are limiting our own flexibility at the same time we collectively, if you want to put it that way, dedicate ourselves to sound money.

Senator MACK. Your point there is that over time, if there were some rather large economies that would join in this concept of dollarization, there would be more pressure on the Federal Reserve in determining monetary policy.

We would be making the statement right now that the Federal Reserve is not going to be affected by what's happening in these other countries. Is that the point that you are making?

Mr. TRUMAN. Yes, that's true too. But now the dollar is more or less free to fluctuate against—for the sake of example, let's stay just with the Western Hemisphere—two of the three major currencies. The dollar fluctuates against the Brazilian real and the Mexican peso, but not against the Argentine peso. Basically that's the choice that has been made by Mexico, Brazil, and Argentina. In the way in which the world works now, that's their choice, and we live with the consequences. Whether we approve of it or not, that's their decision.

If you found all three of those countries completely dollarized, and they became, as we would hope, very successful, it may not be obvious that the exchange rate between the United States and let's

call it "ABM"—Argentina, Brazil, and Mexico—should be fixed at the same point it was fixed in the year 2000. That doesn't mean that the system can't work, but it may not be optimal, even from our standpoint.

We may say the dollar should appreciate because we are being more productive, or something similar to that, or it may be that their accelerated growth associated with this process would be one where they have become so productive that the right way to deal with that would be to allow their currency to rise relative to the U.S. dollar at that time. Again, it is not an either/or proposition, but potentially we would be giving up some degree of exchange rate/monetary autonomy in that process.

It is very much down the road as to whether that would be something we would be concerned about, but it is a potential cost.

Senator MACK. I am going to ask one more question. This is on the seigniorage. I am going to turn to you for an answer, then go to Senator Bennett.

In deciding to rebate 85 percent of currency profits, rather than some other amount, we had to balance a few concerns. We had to give back something less than 100 percent to accommodate higher costs for the Federal Reserve, offer rebates to countries that have already dollarized—of course, the only one that I am aware of is Panama—and make sure the United States does not lose revenue in the process. On the other hand, we have to make the rebate attractive enough to countries so that countries will feel adequately compensated.

Do you have a sense about whether 85 percent is the correct amount? What is your response with respect to that?

Mr. TRUMAN. My response to issues like this, I think, would be inherently somewhat arbitrary, and I think we are better off probably recognizing it would be arbitrary.

I believe the notion that 85 percent provides some cushion—if you want to put it that way—some reassurance to the American taxpayer that you are not providing too much, or from the standpoint of the other country, too little—an unfair amount or too generous an amount—seems to me to make sense. Whether the right number is 95 percent or 75 percent, I don't think one can prove on an a priori basis. I believe it is the case that you cannot be sure, partly because you can't count the dollars.

We need to recognize that we are dealing in a world of approximations. As long as we say this is a reasonable approximation, it doesn't make a difference that it's not precise because the amounts of money from our standpoint are relatively small as a share of GDP or even as a total amount of U.S. revenue. It doesn't make a difference even when you are dealing with relatively large countries like Brazil, Argentina, or Mexico, which are the three largest Latin American countries.

As long as one is prepared to live with the outcome of the consequences of imprecision—and in some sense it comes back to my earlier point about a broad political buy-in to that framework or particular approach—then there is no particular inherent problem with the precise number because you are dealing, from a standpoint of the United States, with a small number.

For example, if you took all three of those countries, their total currency in circulation is something like \$50 billion at the moment. If you applied an interest rate of 5 percent to that total—such as the Treasury bill rate which you call for in your legislation—that would be \$2.5 billion a year.

That is something like $\frac{3}{100}$ of a percentage point of U.S. GDP. It is not a big number, and you still have to take 85 percent of that. It then becomes less than $\frac{2}{100}$ of a percent of GDP. That is not a huge number, but one would want to understand that this is a payment that the U.S. Treasury would be making quarterly to another country.

That is one of the questions which more or less automatically come up, depending on how those aspects of the legislation were to be specified.

We need to recognize that this lack of full precision would be inherent in any approach.

Senator MACK. Senator Bennett.

OPENING COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman, both for the hearing and for the bill, because I think this is an issue that gets ignored and swept aside in the morning's headlines. It is something that we need to spend a good deal of time on, and I am grateful to you, Mr. Chairman, for keeping the issue alive.

First, Mr. Truman, I would like for you to confirm my understanding. I understand that Panama is the only other country that currently uses the dollar.

Mr. TRUMAN. I believe there are five or six other independent countries that also use the dollar at the moment: Micronesia, the Marshall Islands, Palau, and the Turks and Caicos Islands in the British West Indies. There are a number of other small countries currently using the dollar.

Senator BENNETT. All right. My understanding is that Argentina and Hong Kong are the only two countries that tie their currency to the dollar, so that, in effect, there is no exchange rate. They have a currency board in Argentina, and they have a defense of the Hong Kong dollar, but it stays, I think, seven to the U.S. dollar. Is that correct?

Mr. TRUMAN. There are a number of countries who have fixed exchange rate regimes that tie their currencies to the dollar. Argentina and Hong Kong are the ones which have gone to currency board-types of arrangements. It's slightly different in each case.

They have a much tighter band, essentially. There is no fluctuation limit at all except for that associated with transaction costs.

Senator BENNETT. But there are other countries of the world who have fixed exchange rates with the U.S. dollar. I was intimately involved in the Mexican peso crisis. Senator Dole handed that one off to me.

In a setting similar to this, I asked Alan Greenspan, during that crisis, if Mexico had been on a gold standard, would they have had a peso crisis? His answer was no. He said the gold standard would have prevented that crisis.

In a way, we are doing the same thing if we peg all of the currencies in the world to the dollar as if we went on a gold standard.

The gold standard has more of a historical cache to it, but ultimately what we are talking about, when we talk about a gold standard, is we eliminate exchange rates and tie everything to a single commodity—in this case, gold.

It could just as easily be copper wire or some other commodity, but in this case we won't tie it to a commodity, we will tie it to a currency. Is that a fair description?

Mr. TRUMAN. Yes, I think it is a fair description. I don't want to contradict Chairman Greenspan, since I have no doubt I was sitting behind him when you asked that question, however, I would make two qualifications: One is that there always is the question with the gold standard as to whether the country is going to abandon it as has been done from time to time.

That is always an option, so you would still have the question what would have happened if they had been on the gold standard. That is the second qualification, which I have heard Alan Greenspan respond to. His full answer says: If they did everything else that was necessary to make the system work, then they would not have had the crisis.

I believe that's correct. If they had done all of the other kinds of things that would make the system work and they understood that the gold standard or that dollarization was to be supported by other institutions and other dimensions of responsible macroeconomic and microeconomic policy, then, indeed, they would have avoided the crisis. I think that is correct.

Senator BENNETT. I don't want to spend a lot of time on the gold standard.

Mr. TRUMAN. But I think your way of thinking about it, by the way, in reference to the framework is right.

Senator BENNETT. As you get into globalization, which I do want to spend time on, the whole question of flexible currencies becomes, I think, pernicious. It works against globalization. I will not have a tariff barrier because I have signed up with the WTO, NAFTA, or an expansion of NAFTA, but I will, nonetheless, produce a form of protectionism by jiggering my currency in such a way as to effect international trade.

The "beggar thy neighbor" attitude toward international trade—I remember a conversation I had during the Mexican peso crisis with a top Mexican official who said, "But, Senator, we are now more productive by virtue of the devaluation of our currency."

I am afraid I got a little tough with him. I said, "Sir, if you think having employees who now cannot buy American goods, who go home to wives that are weeping because they can't pay the mortgage anymore, who have seen their savings lose 20 to 30 percent of their value in terms of any international purchases, who then have to turn around and come back to work, having had that experience at home with their wives and having had to deal with their own personal financial situation, is a more productive system, you have obviously never run a business."

Those employees are not more productive as a result of that experience. They are far less productive on the production line and in their cubicles, or whatever it is they do.

The human toll you pay when you play around with currencies, particularly for people for whom their entire economic wealth is

represented by currency, is a very real toll. These people do not have assets that can rise and fall in respect to this. Their whole savings and economic base is represented by currency.

Currency is much more important than a lot of people realize, and having a common currency around the world has a tremendously intriguing prospect in terms of the kind of stability that it might bring into the lives of individuals.

Now, I want to get your comment about all of this, but, first, I want to take you to Russia. The last time I had an economic discussion about Russia, I was told that there were three economies in Russia. There is the ruble economy, and the ruble is losing value all the time. It has reached the point where it is, for many people, a joke. There is the barter economy, which automatically arises when the currency loses value and trustworthiness. And there is the dollar economy.

At the time I had the conversation—and this was some years ago—I was told there was over \$30 billion in circulation in Russia, and it was the only hard currency. I was also told that not all of the \$30 billion in circulation in Russia were printed in the United States, that much of it was homegrown.

I suspect that the dollar economy is now larger than \$30 billion in Russia. The amount of currency circulating over there, whether printed there or here, is an even more significant part of their economy than it was at the time I was given that figure.

This, again, represents a yearning for stability, whether it is Argentina, Hong Kong, Mexico, Russia, or wherever. Their desire to stabilize their currency and bring a degree of predictability to their savings and their future purchasing power is, I think, a very strong human emotion and desire.

Doesn't Senator Mack's bill and the suggestion that we encourage dollarization move in the direction that will: (a) satisfy that human yearning on the part of people who want some kind of predictability and stability, and (b) give us a tool against protectionism that would manifest itself in people trying to halt the march of globalization by jiggering exchange rates, or have I missed the boat completely?

Mr. TRUMAN. No, this is a complex issue, but I think I would agree with a very high fraction of what you said.

There really are two dimensions, it seems to me, of the case for common currency. They are based on the traditional thought about what is money. One is there is a transaction demand for money, and the other is there is historical value.

You emphasized, in particular, in your last remarks about Russian historical value, that if you can't trust the ruble, you trust the dollar. You keep your savings in dollars in currency form if you have to, because you can't trust either the banking system or your domestic currency.

By the way, my understanding is that my former colleagues at the Federal Reserve now estimate that the number is twice the \$30 billion that you were told some years ago.

You have that component, then you also have the other component, which comes to your comment about the trading system, and that is the efficiency gains associated with being able to transact.

We have to do transactions in the United States. If we have a Maryland dollar, a Virginia dollar, a District of Columbia dollar, a Utah dollar, and a Florida dollar, it would be inconvenient to ship things around the United States because we would have to pay someone to make those exchanges all the time, even if the country were completely tied together, so there are efficiency gains as well.

On the issue of the trading system, I think that fundamentally I agree with you. I think I would make a distinction, however, between something you said in the course of your remarks about countries that play with their currency, because I think therein lies the crucial element.

The "beggar thy neighbor" notion was in a world in which people could devalue their currency and hold it there. The interesting question about today's world is the difficulty of holding it there. That is why you have Mexican and other kinds of crises. Either the economic policies are not there to make it possible to maintain the devalued level or the world conspires to make it very difficult to maintain it.

If countries play with their currencies and use devaluation as a disguised form of raising tariffs, then, clearly, it is pernicious as far as the trading system is concerned. It is not as clearly pernicious if they are all the way at the other extreme, where they have a completely hands-off view of their currency—they don't intervene in the foreign exchange market at all, they have a completely freely floating exchange rate.

The leading example of that in a small-country case is New Zealand, which hasn't intervened in the foreign exchange market for 15 years. Now, the New Zealand dollar goes up and down, and, indeed, people who are active in agricultural trade worry about its going down.

But it is not the case that New Zealand plays with its currency, if you want to put it that way. It has chosen to treat the exchange rate as any other price, even though that may have consequences for New Zealand as well as its trading relations. They lose the efficiency gains. They lose some sense of the historical value notion that is associated with holding on to New Zealand dollars.

There is no doubt more people hold money outside the country than would otherwise be the case if they had a single currency.

I think one would want to distinguish between the case in which countries actively seek to manage their currency to gain a competitive advantage and one where they are in an essentially hands-off world, where going all the way to fixity is, for whatever reason, not attractive. They say we can't hold things in the middle; we will go to the other extreme of treating foreign exchange as just one more price and have the consequences of that.

If the whole world were on freely floating exchange rates, the implications for the trading system probably would be somewhat less trade. It would be inefficient. Therefore, you might argue that you want to have some intermediate step, because you would have more exploitation of comparative advantage, but basically I agree with you.

Senator BENNETT. I appreciate the indulgence of the Chairman. I have one final question that I believe probably can be answered fairly quickly.

Currency represents the noninterest-bearing portion of the national debt, so theoretically we would be better off if the entire national debt were in currency rather than in notes on which we have to pay interest.

Would a rush to dollarization be in any way significant enough to lower the cost of carrying the national debt as we issue additional currency?

Mr. TRUMAN. I haven't done the calculations. I think, before you came in, I made a calculation that the amount of domestic currency circulating in Brazil, Argentina, and Mexico is \$50 billion. The \$2.5 billion we would gain strikes me as insignificant. I mean, every little bit counts, but it is not, it seems to me, going to be, in and of itself, that significant. It would take quite a number of years to pay up the national debt with \$2.5 billion a year.

Senator BENNETT. Thank you.

Thank you, Mr. Chairman.

Senator MACK. I have another question to pose to you with respect to whether we should have a section in the bill that would make it clear that countries are free to dollarize, even if they don't share in the seigniorage. Do you believe that would be beneficial?

Mr. TRUMAN. That is probably more of a foreign policy question than an economics question, but I think it is a political issue, and there obviously would be some merit in making that option clear, first of all, as a statement of fact.

Second, such a section would make it clear that the fundamental decision is a decision by the foreign country, theirs to make and theirs to take the responsibility for.

I believe that having a section in the bill clarifying this would be beneficial.

Senator MACK. The bill directs payments to the Exchange Stabilization Fund if a country is in arrears on any debts owed to the Exchange Stabilization Fund. Do you have an opinion on that particular section of the bill?

Mr. TRUMAN. We try, as you know, to be very careful about when we use the Exchange Stabilization Fund, so I would hope, first of all, that we would try never to be in a situation in which that became relevant.

I think there is a question, in terms of this framework—and it is one of the deeper questions involved in thinking about these problems—about the circumstances in which you would interrupt the payments to the dollarizing country. It is perfectly natural to think, well, if they are not paying us back, we will just use the offset to compensate for the fact that we are not being paid. That is very logical. On the other hand, it also, to some degree, impairs the framework itself.

It would become a slightly conditional promise, on our part, to do this. One would want to think about, basically, how that would be perceived by the foreign country, as well as the implications—especially if you set this up in terms of a payment on a security, though that wouldn't be the only way to do it—in terms of the acceptance of U.S. securities, generally. Not that these would be special, at least in one regard. The question is how special would you want to make them if you did that.

I think there would be questions about how a conditional payment would be perceived. I believe that would be one of the things we would want to think hard about in any kind of legislation or agreement on this subject.

Senator MACK. In attempting to judge what you said there, I gather that your instincts are saying it probably is better not to have that in the bill, as opposed to it being in there.

Mr. TRUMAN. I mean, just off the top of my head, one could argue it is interesting. It is a fact that we haven't made any Exchange Stabilization Fund loans to Panama, for example. I know when I was at the Federal Reserve they often came by and said, "We are in a pickle. Can't you lend us some money?" We would say, "Go see the Treasury Department." Actually, I think there may have been one loan back in the late 1930's, early 1940's.

In fact, I think one would want to probably even have a higher threshold that would apply to any Exchange Stabilization Fund transaction with a dollarized country for many reasons, which all of you, I think, can articulate at least as well as I can. If you did, you might want to do something ad hoc, so if there was a commitment that we, for whatever reason, made a loan—an Exchange Stabilization Fund loan to a dollarized country—we might want to state why in that circumstance, as part of the agreement. That would be another way of approaching it, rather than, again, locking it in stone.

I am told that we did do an arrears clearing operation with the Exchange Stabilization Fund in the early 1990's with Panama. It was in getting them back on track.

Senator MACK. Several times this morning—and maybe it was in your opening statement—you said if a country were to dollarize, they would give up mechanisms to cushion the economy. I think that is paraphrasing, but isn't that what the trade-off is?

I mean, the countries that would even consider this are the ones that have probably overused methods to cushion the economy instead of making the right kind of economic decisions.

Argentina, even with the currency board, has considered dollarization because they know they are still paying a premium and they want to reduce the premium as much as they possibly can. They are even willing to go to the next step.

Again, the country that pursues this idea of dollarization accepts the notion that they would be giving up an ability to cushion the economy.

Mr. TRUMAN. I think that is absolutely right. I mean, to the extent that the cushioning mechanism has been overused or misused over time, and therefore in some sense has been short-circuited or, in fact, has become anticipated, even if it is going to be used correctly tomorrow, the market may not realize it is going to be used correctly.

Naturally, you could ask the question: What good is an instrument that tends to have negative implications when it is used?

The counterargument, which I only put forward as a counterargument, is whether a country wants to think about earning back the credibility of its discretionary monetary policy.

An example is Canada. Canada, off and on, has had a fixed exchange rate with the United States. You might say, given the inte-

gration of the two economies, it is logical that we would use one currency. However, certain sovereignty issues are involved.

Many people for many years said it was impossible for Canadian long-term interest rates to be lower than U.S. long-term interest rates, because they had a history of higher inflation, and so forth and so on.

More recently, Canadian long-term interest rates actually have gone below U.S. long-term interest rates, but that has been a very long, drawn-out process. You might argue that they have "earned," if you want to put it that way, the capacity to judiciously use this cushioning element.

That has taken a long time, and I think, again, that is a question for the authorities of the country to decide. It is a political decision. It is for them to decide whether it is right to say this is germane, whether, in theory, it might be quite useful, but our leaders tend to misuse it all the time. We would rather discard it, so that, on average, we have a much better monetary policy even though, in difficult times, that might be inconvenient because our economy is behaving differently than the U.S. economy is behaving.

I believe that is the right way to think about the problem.

Senator MACK. My last question is where do we go from here? Are you and your staff willing to work with my office on the various components that we have raised here today?

Mr. TRUMAN. We are always at your service.

Senator MACK. Is there anything you would like to add?

Mr. TRUMAN. No, Mr. Chairman. Thank you.

Senator MACK. I thank you very much.

Mr. TRUMAN. Thank you very much.

Senator MACK. The hearing is adjourned.

[Whereupon, at 11:10 a.m., Tuesday, February 8, 2000, the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JIM BUNNING

Mr. Chairman, I would like to thank our witness for testifying today.

As more and more countries in Latin America move toward using the dollar as their currency, both officially and unofficially, we need to study and explore the possible ramifications of these actions. I am very interested in hearing about your bill, Senator Mack, and the Department of the Treasury's opinion on it.

This is a very interesting issue that could have long-term consequences on our country's relations with the rest of our hemisphere. More and more Latin American countries are looking toward dollarization, Ecuador being the latest. How this will affect relations between our country and Latin America is something we must study thoroughly.

Senator Mack's bill would make it easier for countries to convert to the dollar by allowing the Treasury to reduce seigniorage. The seigniorage reduction will reduce both budget and political hurdles that countries considering dollarization currently face.

The news of Ecuador's dollarization makes this hearing even more timely. I applaud you, Mr. Chairman, for holding this hearing and for your hard work on this issue. I look forward to hearing the opinions of the Treasury on this issue. I also want to continue to learn from you, Mr. Chairman, about your views on this issue and about your bill.

Thank you very much, Mr. Chairman.

PREPARED STATEMENT OF EDWIN M. TRUMAN

ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. DEPARTMENT OF THE TREASURY

FEBRUARY 8, 2000

Introduction

Mr. Chairman, thank you for the opportunity to testify on the issue of dollarization and your proposed legislation that would establish a framework for potentially sharing seigniorage with countries that decide to dollarize. Given the interest in dollarization recently expressed in several Central and South American countries, your initiative is highly relevant. The issue of dollarization has many economic, financial, and political dimensions. In my testimony, I focus primarily on the economic and financial aspects.

As the Administration has stated in prior testimony on the subject of dollarization, we do not have a view on whether dollarization is advisable in general. Each country, in principle, can dollarize unilaterally, and it must bear the responsibility to decide in light of its own economic and political circumstances if dollarization is the appropriate policy to pursue.

From the U.S. perspective, as Secretary Summers testified last April, it would not be appropriate for U.S. authorities to adjust the procedures or orientation of U.S. monetary policy in light of another country's adoption of the dollar, to extend banking supervision to that country's banks, or to provide access by those banks to the Federal Reserve's discount window. We have not changed our view. On the issue of sharing seigniorage, as we have said earlier, congressional action would be required to permit the United States to pay seigniorage to a dollarizing country. Furthermore, we believe strongly that, during the process of deciding whether to share seigniorage with any given country, there should be extensive consultation by the Administration with the Congress to limit the scope for subsequent problems. The technical issues associated with dollarization are many and complex, and we also would certainly want to draw upon the expertise of other agencies, including the Federal Reserve.

Considerations for Dollarizing Countries

A country's decision to end the legal tender status of its national currency and to bestow that status upon the U.S. dollar is very momentous, regardless of the circumstances. The reasons a country may choose to dollarize can be varied, and the benefits are potentially significant. However, it is essential to remember that dollarization cannot substitute for sound macroeconomic policies, robust institutions, and flexible markets. The principal economic benefits of dollarization are the credibility and policy discipline derived from its implicit irrevocability. Its principal economic cost is the renunciation of national monetary autonomy.

The basic trade-off associated with dollarization is between the advantages and disadvantages of a regime with some degree of exchange rate and monetary policy

flexibility and a regime with none. Exchange rate adjustment is a potential shock absorber and also allows greater scope for national monetary autonomy. However, that potential must be balanced against the added macroeconomic policy discipline and credibility associated with rejecting all scope for discretionary monetary policy and adopting the currency and monetary policy of another country with such credibility. As in all meaningful trade-offs, judgments about the appropriate balance can differ across countries and their circumstances. Moreover, sound fundamental policies and institutions are needed in order to underpin any credible currency regime. In particular, a dollarizing country, like all countries, should have a sustainable fiscal position, a healthy banking system, flexible and well-functioning labor markets, open capital markets, and an environment in which private property is respected and contracts are enforced.

In addition to assessing its economic fundamentals, a country considering dollarization must weigh carefully the potential benefits against the potential costs. On the one hand, the implicit irrevocability of dollarization holds the promise of lower interest rates, lower inflation rates, much higher levels of economic activity, greater financial stability, and deeper financial markets. These benefits can be expected to be especially attractive to a country with a record of financial instability and high inflation, but financial and fiscal crises may still occur with dollarization.

On the other hand, the monetary authorities of a dollarizing country would be ceding the capacity to use monetary or exchange rate policy to cushion the economy against economic or financial disturbances. Moreover, there is no guarantee that the exchange rate used to convert a country's domestic currency into dollars, thereby fixing that exchange rate irrevocably, will be the right exchange rate for the near term. Setting that conversion rate either too high or too low could have adverse implications for the real economy's short-term performance. Over time, if domestic prices and wages cannot adjust rapidly in response to disturbances, dollarization could also mean greater volatility in output and employment. Dollarization should not greatly impede the ability of the authorities to provide very short-term liquidity to individual banking institutions, but the authorities would lose much of their scope to respond to a systemic threat to the banking system.

For a country that has already made a strong commitment to a permanently fixed exchange rate, the balance of considerations with respect to dollarization differs. The scope for adjustment working through the exchange rate or domestic monetary policy is, in principle at least, already limited. Thus, the effective costs of dollarizing may be lower, along with the effective benefits. However, even a fixed exchange rate regime has an exit option, which is presumed to be lost with dollarization. Nevertheless, it is worth noting that many observers, including Paul Volcker, have suggested that, in the wake of continuing globalization, the years and decades ahead may see a dramatic decline in the number of independent currencies in the world.

Considerations for the United States

Obviously, countries can choose to adopt the dollar as legal tender without our assent. However, we hope and expect that countries would consult with us in advance because there are potential benefits as well as costs to the United States from the adoption of such a policy. The benefits include increased seigniorage; reduced transaction costs for U.S. resident importers, exporters, borrowers, and lenders; the possibility of increased business for U.S. banks and other financial institutions; and the "power and prestige" that might be associated with having a more international currency. Indirectly, the United States would benefit from the increased economic activity or greater financial stability that would be expected in the countries that dollarize successfully.

However, dollarization also involves potential costs or potential burdens for the United States. U.S. economic and regulatory policymakers could come under pressure from the authorities of the dollarized country to help support their economy's economic and financial stability. Questions have likewise been raised about the possible impact on attitudes toward the United States in a dollarized country at times of financial stress. To the extent that dollarization furthered economic and other ties, this would normally be expected to be seen as a benefit to both the United States and the dollarized country. However, in difficult times, or when U.S. monetary policy is considered inappropriate or inconvenient for the dollarized country, there would be the risk that U.S. policies would foster resentment and encourage policymakers to deflect blame for their countries' problems onto the United States. Finally, if a substantial number of large countries should choose to dollarize, the monetary and exchange rate flexibility currently enjoyed by the United States itself would potentially be reduced.

Seigniorage Sharing

A decision by another country to adopt the dollar as its currency would increase U.S. seigniorage revenues—in effect lowering the cost of financing U.S. Government debt and improving the U.S. fiscal balance—because such an action would be expected to lead to increased holdings abroad of dollar currency. However, the size of this increase in the short run, let alone over time, remains an unanswered empirical question. The question of whether it would be appropriate to share those revenues or savings is an important public policy question.

As noted above, dollarization may bring potential benefits to the United States as well as the dollarizing country, but also potential costs.

Looking at seigniorage sharing narrowly, in principle, a decision by the United States to share the seigniorage revenues associated with the increased amount of dollars in circulation as a consequence of a country's decision to dollarize would not cost the U.S. taxpayer anything. However, if a country would have dollarized anyway, or has large amounts of dollars circulating already, then sharing seigniorage by the United States would imply foregoing additional seigniorage revenues. At the same time, if the benefits of dollarization to a country are significant, they should outweigh the lost seigniorage. In other words, the deciding factor for either country should not be whether seigniorage would be shared.

One added potential risk to the United States from the sharing of seigniorage is that it may imply a degree of U.S. endorsement or ownership of a country's decision to dollarize. Unless carefully designed and implemented, dollarization also could lead to unintended legal or financial complications and potential liabilities for the United States, particularly if a country seeks creative ways in which to meet its banking system's short-run liquidity needs—to provide lender-of-last-resort support for the domestic banking system—by securitizing potential seigniorage flows.

Sharing of dollar seigniorage raises complex questions. For example, where would we draw the line on the sharing of seigniorage? If the United States decided to share our increased seigniorage with one dollarizing country, does that mean we would stand ready to share it with all countries that we view as meeting the economic criteria for dollarization and seigniorage sharing? How would we decide the right amount of seigniorage to share?

Senator Mack's proposed legislation suggests answers to some of those questions. He has contributed importantly to the intellectual debate on both dollarization and seigniorage sharing. The proposed legislation is one approach to arrangements for potential seigniorage sharing: that is, pass legislation to give the Treasury Secretary discretionary authority to rebate seigniorage to a specified degree to any country that makes such a request as long as it meets certain conditions. That approach has the advantage of providing a country that is considering dollarization with a framework within which to contemplate its decision and, in the process, may encourage responsible dollarization.

On the other hand, each country is likely to come to its decision to dollarize in the context of different economic, financial, and political circumstances, and U.S. attitudes toward that decision may differ depending on those circumstances. Another approach, therefore, would be to wait until a country makes a concrete request to share seigniorage and then consider specific legislation that would enable us to do so under the particular circumstances.

Let me mention some of the technical issues and complexities that would be involved in seigniorage sharing. The calculation of the appropriate amount of seigniorage to share is tricky. The Federal Reserve has only estimates of the total amount of dollars circulating outside the United States. We have no way of knowing the actual amount circulating abroad, and estimates of the amount used by the residents of any one country are even rougher. Thus, any formula for sharing seigniorage inherently would be only an approximation of the actual seigniorage "lost" by the dollarizing country or "gained" by the United States as a result of a country's decision to dollarize.

If it were decided to adopt seigniorage sharing as U.S. policy, important implementation challenges would arise in order to have reasonable confidence that the "right" amount is shared. U.S. taxpayers would want some assurance that they are not being exploited by seigniorage "rebates" to foreign countries in excess of additional seigniorage that is being "gained" by the United States. While the approach suggested in the proposed legislation is plausible, several considerations would arise about its actual implementation. These include:

- Recognition that we would have no way of knowing the actual amount of U.S. currency in circulation in a given country at any point in time.
- Second, it cannot be fully guaranteed that a country would not receive more than its "fair share" of seigniorage revenues. For example, the formula in the

Chairman's proposed legislation assumes implicitly that the dollarized economy has the same income elasticity of demand for currency as the United States and other countries in the world that use dollars. If the income elasticity of demand for currency were lower in the dollarizing economy, the seigniorage sharing calculated by the formula would be too large. This would also be the case if the demand for cash in the dollarizing country were to fall as the demand for other monetary aggregates rose, for example, as a result of enhanced intermediation or the repatriation of flight capital.

- Third, some might raise questions about the appropriate interest rate to use as a proxy for the opportunity cost of holding cash in dollars. This is also not a matter that can be settled on a factual basis. One could argue that the interest rate on U.S. Government bonds would be appropriate because that rate most closely reflects the long-term liability nature of money. One could also argue that the 90-day Treasury bill rate, as specified in the proposed legislation, is more appropriate because it is a good proxy for the opportunity cost of holding reserves, as well as for the net return on the Federal Reserve's portfolio. Given the generally upward slope of the U.S. yield curve, the use of a short-term interest rate has the added benefit of being more conservative from a U.S. perspective than the use of a long-term rate. A third concept might be the rate that the dollarizing country would have earned on its dollar-denominated assets, which depends on the composition of its portfolio of such assets.
- Fourth, any approach for sharing seigniorage with countries that have already officially dollarized inherently cannot be expected to reflect with complete accuracy a country's actual holding of dollars now or in the future.
- Fifth, some might raise questions about whether there should be some allowance for the ex-ante partial, but substantial, dollarization of countries, such as Argentina, that ultimately decide to fully and officially dollarize.

Nevertheless, these questions have reasonable answers as long as one is prepared in some instances to be satisfied with less than full precision.

I should also note that an approach to sharing seigniorage by means of paying interest on a consol issued by the United States would raise issues about the status of this security under the laws that govern the management of U.S. debt. Moreover, issues about the budgetary treatment and the full legislative implications of sharing seigniorage would have to be addressed.

Let me make one final comment on Chairman Mack's thoughtful legislation. The ten factors that the Treasury Secretary would be required to take into consideration in determining whether to certify that a country has officially dollarized, and is then eligible for seigniorage sharing, are definitely relevant to any such determination. However, there may be other important factors to consider as well before we decide to share our increased seigniorage. For example, dollarization is more likely to succeed in a given country if, at the time of dollarization, a country's foreign reserves cover at least the local currency in circulation, and the commitment of the country's citizens to dollarization is high. Furthermore, the economic and financial context in which dollarization takes place can also play an important part in determining its success. Dollarization as part of a coherent, long-term economic strategy is likely to be more successful than dollarization in response to a financial crisis. The latter is more likely to involve hasty decisions with unforeseen consequences.

Conclusion

In conclusion, again I want to commend you, Mr. Chairman, for your thoughtful proposal and many contributions to a complex and increasingly relevant policy discussion. We will want to continue an open dialogue with the Congress and other interested parties as we proceed to analyze further the many facets of this subject.

Thank you, Mr. Chairman and Members of the Subcommittee, for your time. I will be happy to respond to any questions you may have.

106TH CONGRESS
1ST SESSION

S. 1879

To promote international monetary stability and to share seigniorage with
officially dollarized countries.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 8, 1999

Mr. MACK introduced the following bill; which was read twice and referred to
the Committee on Banking, Housing, and Urban Affairs

A BILL

To promote international monetary stability and to share
seigniorage with officially dollarized countries.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 SECTION 1. SHORT TITLE.

4 This Act may be cited as the “International Monetary
5 Stability Act of 1999”.

6 SEC. 2. FINDINGS; STATEMENT OF POLICY.

7 (a) FINDINGS.—Congress finds that—

8 (1) monetary stability is a prerequisite for
9 strong long-term economic growth and increasing
10 standards of living;

1 (2) many emerging market countries lack monetary
2 stability and have therefore suffered economic
3 and financial problems that suppress economic
4 growth and living standards, including financial fragility,
5 inflation expectations that are built into labor
6 markets, and high and volatile inflation rates and interest
7 rates;

8 (3) many emerging market countries have used
9 pegged exchange rate systems to try to foster monetary
10 stability and have experienced temporary periods
11 of higher economic growth and lower inflation
12 followed by drastic balance of payments problems,
13 steep devaluations, and major losses in international
14 reserves;

15 (4) emerging market countries that have adopted
16 currency board systems have enjoyed higher rates
17 of economic growth and lower interest rates, although
18 interest rates have remained higher for loans
19 denominated in the local currency than in the anchor
20 currency;

21 (5) since the financial and economic crisis that
22 struck Asia in 1997, there has been growing international
23 interest in official dollarization, whereby a
24 country would substantially or totally eliminate its

1 domestic currency and adopt the United States dol-
2 lar as legal tender;

3 (6) official dollarization would let a country im-
4 port monetary stability, thereby bringing inflation
5 and interest rates down toward the levels of the
6 United States;

7 (7) official dollarization would make it impos-
8 sible for governments to print domestic currency to
9 pay for government programs, thereby promoting
10 fiscal discipline;

11 (8) official dollarization would make it easier
12 for people to conduct financial transactions in the
13 currency they use for daily commerce, thereby pro-
14 moting deeper financial markets;

15 (9) lower inflation, interest rates, and inflation
16 and interest-rate volatility, greater fiscal discipline,
17 and deeper financial markets would increase long-
18 term economic growth and raise living standards in
19 emerging market countries;

20 (10) by increasing trade and investment flows
21 and decreasing the need for foreign assistance,
22 greater economic growth and higher living standards
23 abroad would serve the interests of the United
24 States;

1 (11) countries that become officially dollarized
2 would lose seigniorage (the profit from issuing a cur-
3 rency) and this is a significant barrier to official
4 dollarization;

5 (12) official dollarization would increase the sei-
6 gniorage earnings of the United States;

7 (13) it would be mutually beneficial for the
8 United States to encourage official dollarization by
9 offering to share with countries that become offi-
10 cially dollarized a portion of the extra seigniorage
11 earnings that the United States would earn; and

12 (14) encouraging official dollarization com-
13 plements ongoing efforts by the United States to
14 strengthen the international financial architecture.

15 (b) **STATEMENT OF POLICY.**—It is the policy of the
16 United States that—

17 (1) the Federal Reserve System has no obliga-
18 tion to act as a lender of last resort to the financial
19 systems of dollarized countries;

20 (2) the Federal Reserve System has no obliga-
21 tion to consider the economic conditions of dollarized
22 countries when formulating or implementing mone-
23 tary policy; and

1 (3) the supervision of financial institutions in
2 dollarized countries remains the responsibility of
3 those countries.

4 **SEC. 3. CERTIFICATION.**

5 (a) IN GENERAL.—The Secretary of the Treasury (in
6 this Act referred to as the “Secretary”) may certify a
7 country as officially dollarized, after consideration of
8 whether the country has—

9 (1) ceased issuing a local paper currency;

10 (2) destroyed the materials (such as plates and
11 dies) used to produce such currency;

12 (3) extinguished a substantial portion of the
13 local currency in circulation, with plans to extinguish
14 as much of it as feasible;

15 (4) ended the legal tender status of the local
16 currency;

17 (5) granted legal tender status to the United
18 States dollar;

19 (6) ceased accepting local currency, except in
20 exchange for dollars;

21 (7) ceased making government payments in the
22 local currency;

23 (8) substantially redenominated its prices, as-
24 sets, and liabilities in dollars;

1 (9) either opened its banking system to foreign
2 competition or met international banking standards
3 (such as those described in the Core Principles for
4 Effective Banking Supervision issued by the Basle
5 Committee on Banking Supervision of the Bank for
6 International Settlements); and

7 (10) engaged in advance consultations with the
8 Secretary to determine whether the country is a
9 good candidate for official dollarization.

10 (b) **STATEMENT BY SECRETARY.**—The Secretary
11 shall issue a written statement upon certification of a
12 country under this section that explains why that country
13 has been certified. The Secretary may not certify United
14 States territories or commonwealths as officially
15 dollarized.

16 **SEC. 4. CONSOL.**

17 (a) **ISSUANCE.**—

18 (1) **FACE VALUE.**—Upon certification of a
19 country under section 3, the Secretary shall issue to
20 the dollarized country a consol. Except as provided
21 in section 5, the face value of the consol shall be
22 equal to the amount of dollars exchanged for United
23 States Treasury securities by the Federal Reserve
24 System with the dollarized country for purposes of
25 official dollarization under this Act.

1 (2) LIMITATION.—Face value may not exceed
 2 the dollar value of the local currency in circulation
 3 in the dollarizing country prior to the certification of
 4 that country as officially dollarized under section 3.

5 (b) INTEREST PAYMENTS.—

6 (1) IN GENERAL.—Starting with the first busi-
 7 ness day of the fourth full calendar month following
 8 the date of certification of a country under section
 9 3, the owner of the consol will receive interest pay-
 10 ments every 3 calendar months equal to
 11 $(FV_0)(i)(.25)[(C_2 - FV_2)/(C_1 - FV_1)](85\%)$.

12 (2) DEFINITIONS.—In this Act—

13 (A) FV_0 = face value of the consol issued
 14 under this Act to the country receiving the pay-
 15 ment;

16 (B) FV_1 = face value of all consols issued
 17 under this Act by the end of the most recent
 18 full calendar year prior to the date of certifi-
 19 cation under section 3 of the country receiving
 20 the payment;

21 (C) FV_2 = face value of all consols issued
 22 under this Act by the end of the most recent
 23 full calendar year prior to the payment;

24 (D) i = average yield to maturity on 90-
 25 day Treasury bills in the most recent full 3-

1 month calendar period prior to the date of pay-
2 ment (using the average of monthly interest
3 rates, as calculated by the Board of Governors
4 of the Federal Reserve System);

5 (E) C_2 = total global dollar currency in
6 circulation at the end of the most recent full
7 calendar year prior to the payment (as provided
8 by the Board of Governors of the Federal Re-
9 serve System); and

10 (F) C_1 = total global dollar currency in
11 circulation at the end of the most recent full
12 calendar year prior to the date of certification
13 of the country receiving the payment (as pro-
14 vided by the Board of Governors of the Federal
15 Reserve System).

16 **SEC. 5. PREVIOUSLY DOLLARIZED COUNTRIES.**

17 (a) IN GENERAL.—

18 (1) LIMITATION.—The Republic of the Marshall
19 Islands, the Federated States of Micronesia, the Re-
20 public of Palau, Panama, the Turks and Caicos Is-
21 lands and the British Virgin Islands may not be cer-
22 tified as officially dollarized or issued consols until
23 10 percent of the face value of consols issued to
24 countries other than those listed in this paragraph
25 equals or exceeds the total combined face value of

1 consols that would be issued to the countries listed
2 in this paragraph upon their being certified.

3 (2) CONSOL CALCULATION.—

4 (A) IN GENERAL.—Upon certification
5 under section 3, each of the countries listed in
6 paragraph (1) shall receive a consol with a face
7 value equal to (4%)(Y).

8 (B) DEFINITION.—For purpose of sub-
9 paragraph (A), Y = nominal dollar gross do-
10 mestic product, as calculated by the World
11 Bank (or other recognized statistical authority),
12 as of September 30, 1999, for calendar year
13 1997.

14 (3) PAYMENTS.—Interest payments on consols
15 to countries listed in paragraph (1) shall be made in
16 accordance with section 4.

17 SEC. 6. RIGHTS AND OBLIGATIONS.

18 Owners of consols issued under this Act shall have
19 the same rights and obligations as other owners of pri-
20 vately held obligations of the United States Treasury, ex-
21 cept that a consol originally issued to a country is ren-
22 dered null and void upon a United States declaration of
23 war on the country or a publicly issued statement by the
24 Secretary that the country is no longer officially dollarized
25 in accordance with this Act, but only if such written state-



1 ment lists the reasons for such a finding. In making a
2 determination under this section, the Secretary shall con-
3 sider those factors listed in section 3(a).

4 **SEC. 7. REPURCHASE.**

5 The Secretary may repurchase a consol issued under
6 this Act at market value, but not sooner than 10 years
7 after the date of issuance. Purchases may only be made
8 upon the joint agreement of the Secretary and the owner
9 of a consol. Consols issued under this Act are not callable.

10 **SEC. 8. EXCHANGE STABILIZATION FUND.**

11 Payments on consols issued under this Act to coun-
12 tries that are in default or arrears on loans from the Ex-
13 change Stabilization Fund shall be used to cover such
14 debts.

15 **SEC. 9. REGULATIONS.**

16 The Secretary and the Board of Governors of the
17 Federal Reserve System may issue regulations appropriate
18 to carry out this Act.

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